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DEC 7 1982
ALEXANDER L. STEVAS,
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No. 82-774

In the Supreme Court of the United States

OCTOBER TERM, 1982

PHILIP D. FARMAR AND MARIAN J. FARMAR AND
A.A. SUGG AND MARY S. SUGG, PETITIONERS

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF CLAIMS

MEMORANDUM FOR THE UNITED STATES

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Section 613A of the Internal Revenue Code of 1954 (26 U.S.C.) allows a percentage depletion deduction to be computed with respect to the "average daily production of * * * oil * * * and * * * gas." The question presented by the petition is whether petitioners, who assigned oil and gas leases partly in consideration for lease bonuses, are entitled to a deduction for percentage depletion under Section 613A with respect to these bonuses, which are not tied to the production of oil and gas.

The pertinent facts are undisputed and may be summarized as follows: Petitioners are owners of a mineral estate in lands located in Texas (Pet. App. 1a).[1] They leased

[1]Philip D. Farmar, the Farmar children, and A.A. Sugg were the owners of the mineral interest (See Stip. paras. 5, 16, 17). The Farmar children are not parties in this action. Marian J. Farmar and Mary S. Sugg are parties to this suit solely because they filed joint returns with their spouses. For convenience, references to "petitioners" are to Philip D. and Marian Farmar and A.A. and Mary S. Sugg, collectively.

their ownership interests to two companies interested in oil and gas exploration. As compensation for the agreements, they were to receive cash bonuses payable in several yearly installments; they were also to receive royalties as oil and gas were extracted from the land (Pet. App. 1a-2a). The lease bonuses were payable even if no oil or gas was produced. If the operators abandoned the property, the bonuses were not returnable (Pet. App. 2a n.1).

During 1976, oil and gas were extracted from the property and royalties were paid to the petitioners. The parts of the bonus payments required to be made in 1976 were also made during the year, in the amounts of $528,271.80 to the Suggs and $257,653.90 to the Farmars (Pet. App. 2a; Stip. paras. 11, 24, 25). On their 1976 tax returns, petitioners claimed a 22 percent percentage depletion deduction on both the royalty payments and the lease bonus payments (Pet. App. 2a). The Commissioner of Internal Revenue disallowed the percentage depletion deductions taken with respect to the bonuses.[2] Petitioners paid the resulting deficiencies, and subsequently filed this consolidated suit for refund in the Court of Claims (Pet. App. 1a-2a).

The Court of Claims agreed with the Commissioner that petitioners were not entitled to the percentage depletion deduction with respect to the bonus payments received (Pet. App. 16a). After examining Section 613A of the Internal Revenue Code of 1954, the court stated that "[t]his statutory language regularly linking depletion directly to production during a taxable year indicates to us that Congress wanted depletion to be allowable only 'with respect to' income derived from, or connected with, actual extraction

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[2]There is no controversy as to whether petitioners were entitled to a percentage depletion deduction with respect to the royalties paid during 1976 (Pet. App. 2a n.2).

during the taxable year" (Pet. App. 8a). The court concluded that petitioners "have not met the burden of showing that they are entitled to a deduction under §613A—they have not convinced us that the statute omits the requirement of a direct link to actual production for oil and gas income to be subject to the percentage depletion allowance" (Pet. App. 16a).

DISCUSSION

The decision below correctly held that petitioners were not entitled to a percentage depletion deduction for lease bonus payments.

Prior to the enactment of the Tax Reduction Act of 1975, which added Section 613A of the Internal Revenue Code, the lessor of a mineral interest in consideration for a bonus or advance royalty was entitled to a percentage depletion allowance against such payments, whether or not there was mineral production in the year of payment. *Herring* v. *Commissioner*, 293 U.S. 322, 324 (1934). But the Tax Reduction Act of 1975 changed the law. It generally repealed the percentage depletion allowance for oil and gas, effective January 1, 1975. See Tax Reduction Act of 1975, Pub. L. No. 94-12, Section 501(a) and (b)(1), 89 Stat. 47 and 53. Congress permitted a single exception to this repeal for independent domestic producers and royalty owners. Thus, Section 613A(c) of the Code provides that percentage depletion "shall be computed in accordance with section 613 [allowing percentage depletion] with respect to * * * so much of the taxpayer's average daily production" of domestic crude oil or natural gas as does not exceed a specified depletable quantity. Section 613A(c)(1)(A) and (B). The "average daily production" is determined by dividing the aggregate production by the number of days in the taxable year.

The Court of Claims correctly interpreted Section 613A to limit receipts eligible for percentage depletion deductions to amounts received with respect to actual production. As the court pointed out (Pet. App. 9a), the lease bonus in this case was not tied to actual production, but only to the parties' expectation of production. The statutory language of Section 613A demands a connection with actual, not expected, production (Pet. App. 9a). Because the lease bonuses at issue here are not based on the actual production of oil and gas, percentage depletion should be denied.

For the reasons more fully set forth in our petition for a writ of certiorari (No. 82-599) in *Engle* v. *Commissioner*, 677 F. 2d 594 (7th Cir. 1982) (Pet. App. 17a-31a), which is currently pending before the Court, we agree with petitioners that the decision below conflicts with that case. In *Engle*, the Seventh Circuit held that taxpayers were entitled to percentage depletion deduction for advance royalties which they received during a year in which there was no production of oil or gas. Contrary to the Court of Claims' statement (see Pet. App. 16a), advance royalties and lease bonuses have been treated alike for tax purposes. See, e.g., *Douglas* v. *Commissioner*, 322 U.S. 275, 280 (1944); *Herring* v. *Commissioner*, 293 U.S. 322, 324 (1934).

We therefore believe that it would be helpful to the Court to consider Section 613A in the context of both the lease bonus in the instant case and the advance royalty payment in *Engle*. We therefore do not oppose the petition in this case. The Court may wish to consolidate this case with *Engle* (No. 82-599).

It is therefore respectfully submitted that the petition for a writ of certiorari should be granted.

REX E. LEE
Solicitor General

DECEMBER 1982

DOJ-1982-12